RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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Sept. 25, DJIA 824.01; PTI 1393; A-D Ratio –25.22
Oct. 2, DJIA 860.73; PTI 1405; A-D Ratio –23.98

THE BIG CROSS-UP: For years people were told to "borrow to the hilt like the big boys do – and pay off with cheap dollars." And by 1981 the entire nation was up to its neck in debt. But when everybody thinks the same, nobody is thinking. Now it appears that the nation went into debt with cheap dollars, and they're going to pay off with expensive dollars. That is, if they ever pay off at all!

THE PICTURE: True primary bear markets are always *international* in scope. Whatever affects the fundamentals of one nation (particularly a nation as important as the US) is bound to rub off on other nations. Last week stock markets around the world thundered lower as panic broke out on exchanges across the globe. Many took the idiotic position that Joe Granville was responsible for the carnage. But the fact is that the composite world index (which I keep) has been looking toppy for months, and it gave a sell signal in August. By the same token, the breadth indices on the NYSE (as I have warned about for many months) have been diverging with price all during 1981. In fact, I wrote that the divergence between the Dow and the NYSE A-D ratio (since September, 1980) was the most flagrant I had ever seen.

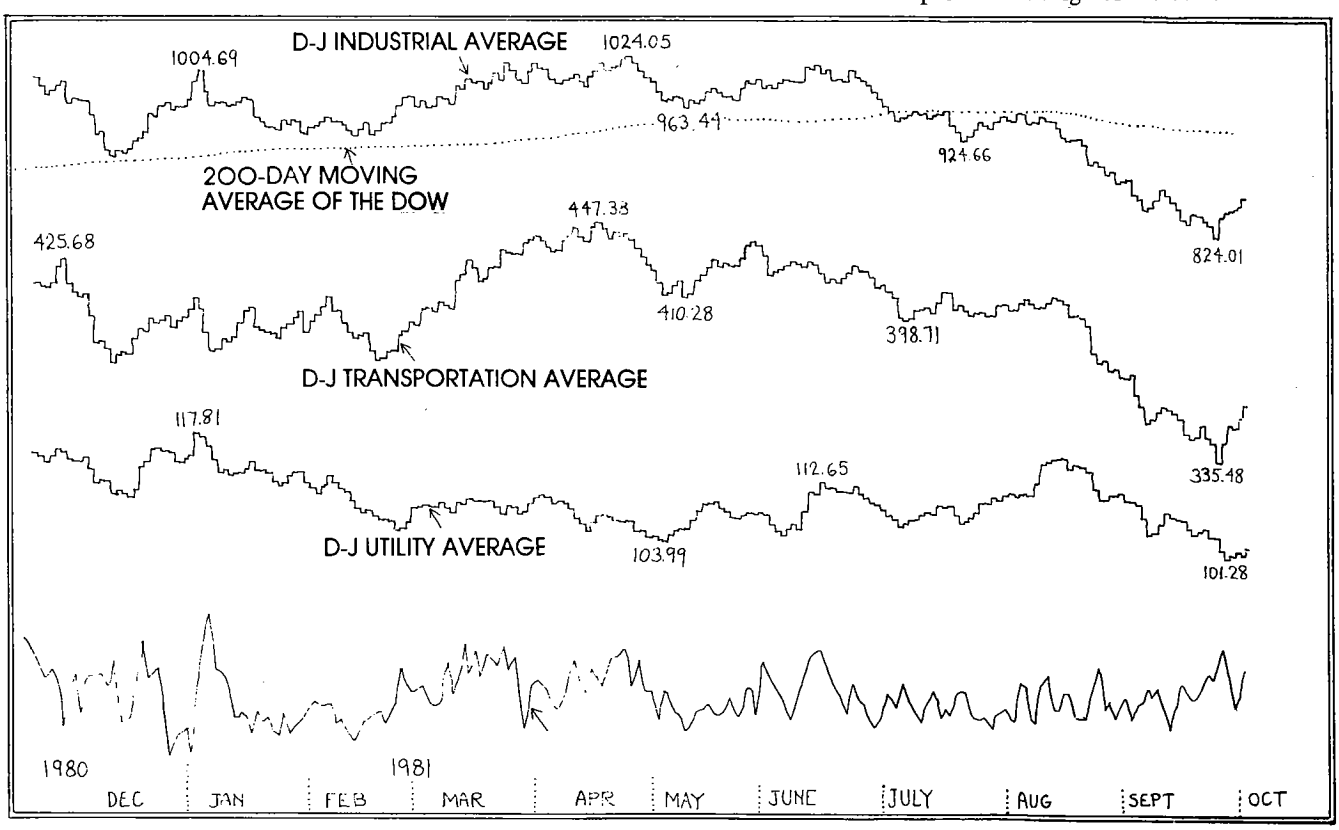
Fortunately, primary bear markets are rare events. A primary bear market is an economic tragedy, comparable to a forest fire in nature or a plague on mankind. But a bear market is also the stock market's bow to physical principles and that law of nature that states that "no tree grows to the sky."

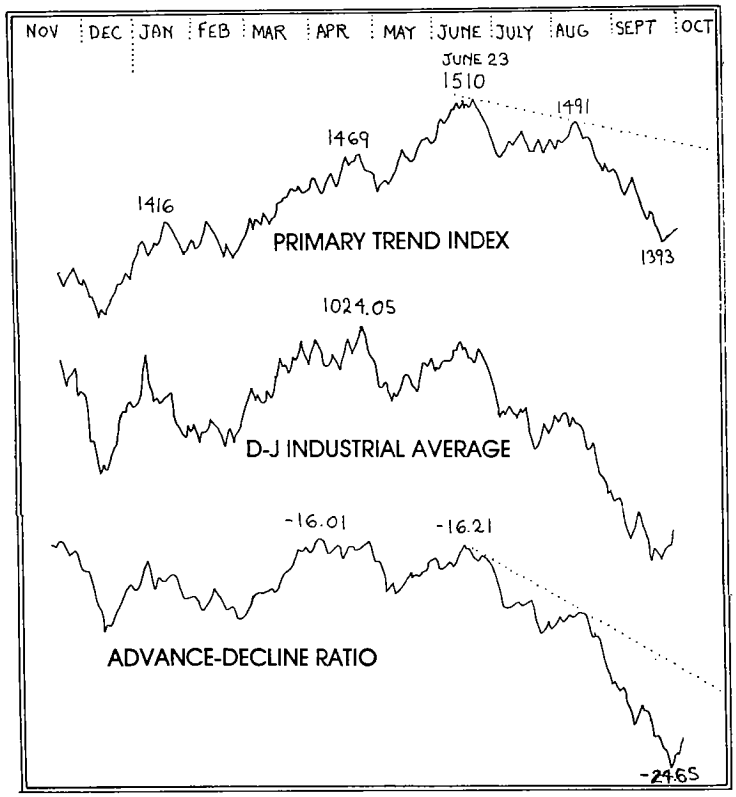
Many people in this age of the "fix" think of bear markets as mistakes or miscalculations by Wall Street, and they respond with plans and schemes to manipulate the nation out of the primary bear trend. This is an exercise in futility. Once the primary trend of the market and the economy turn down, the forces of contraction and correction take hold. And these forces will express themselves no matter what. The more the manipulations and the greater the efforts to hold back the bear, the worse the ultimate result and the more painful the reign of the bear.

FRONT PAGE COMMENT: I said it at the time but I'll say it again: the day President Reagan took office he should have told the American people the WHOLE story of the disastrous US debt build up, the chronic deficits and the required cure, the WHOLE painful cure. Now it's late, very late. Piece by piece, bit by bit, the story emerges, and the public doesn't know what to make of it. As far as the Democrats are concerned, Reagan can whistle for more budget cuts – and then twist slowly in the wind. All this the market knows, and it's anything but a pretty story.

With the tax cuts now law and the budget cuts woefully inadequate, Wall Street is thinking in terms of an $80 to $100 billion deficit for 1982. This is based on continuing high interest rates and a recession (Reagan figured on 7.5% interest rates and 5-7% economic growth). Of such are economic tragedies made.

I look for political stalemates, recriminations, accusations, non-actions in the period ahead. A year ago President Reagan could have risked all – and perhaps gained all. Now the tide has turned and the nation is on the razor's edge. The new economic moves will be generated not by the politicians but by the markets. The year 1982 promises to be a year of reckoning – and pain.





If I could teach subscribers one thing about dealing and operating in markets, it would be PATIENCE. You must give the trend time to fully express itself. On September 28 (amid world turmoil and plunging international markets) the NYSE did plunge, but then came an about face with the Dow closing up 18 points. Immediately, commentators and analysts took heart, and there were widespread announcements that "the turn has come." My own feeling is that we are not at the turn, and that before long the market will be probing lower levels.

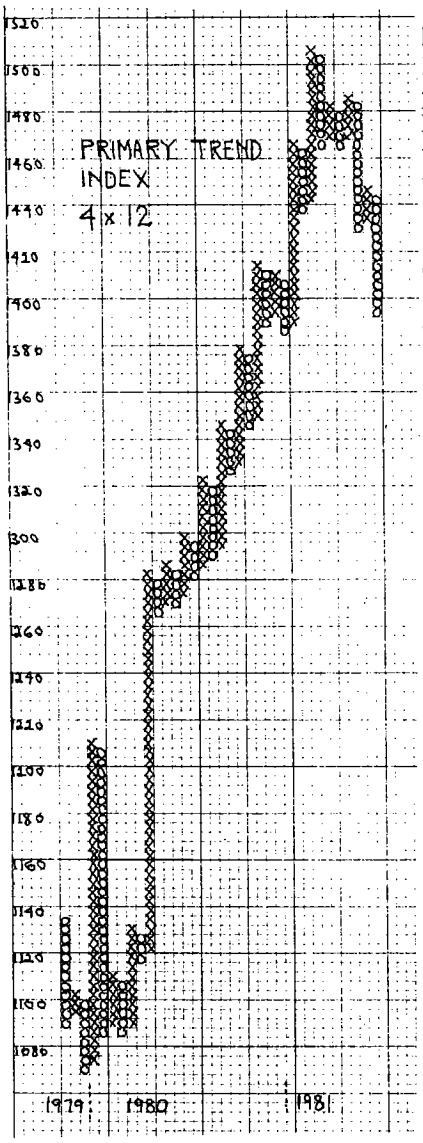
Referring to the page 1 chart, the downside points in the Averages to watch are the September 25 low of 824.01 for Industrials, 335.48 for Transports. The Utility Average (which encouraged so many and which was so reluctant to break with the other Averages) tumbled to a new low on September 28 and is now the weakest of the three Averages. So much for this "bullish" harbinger.

Referring to the above chart of the PTI, it is clear that the PTI downtrend is well established. Nevertheless, the Dow (since July 31) has been down 7 out of 8 weeks, and even a drowning man comes up for air before going under. Thus, the market is temporarily oversold, and a rally from the oversold condition began from 824.01 on the Dow.

Meanwhile, from its June high of minus 16.21 the A-D ratio lost 9 points without so much as a 1 point intervening rally. This fits my definition of a selling panic. Following a panic the market is entitled to some kind of recovery. Don't become blinded by bearishness just because you're out of the market. Patience and judgment are the watchwords to success in this business.

DOW THEORY: One of the foundations of Dow Theory is that the D-J Industrial and Transportation Averages must confirm each other through preceding highs or lows – if the move is to be considered valid. The rationale behind this rule is clear enough: if the nation's industrial capacity (as measured by the Industrial Average) increases, that increase is only constructive if the goods are shipped (and the Transports measure the expansion or contraction in shipping). Conversely, if shipping picks up, it is only constructive if the expansion has a positive effect on the manufacturing segment of the economy as gauged by the D-J Industrials.

With a primary bear market now in progress, it is interesting to note that the nation's manufacturing utilization has now dropped to around 76% (manufacturers are now using only 76% of their full capacity). Confirming this we note that Transport activity is sagging. Union Pacific reports that one third of its locomotives and 5,500 freight cars have been idled. Burlington Northern has idled 27,000 cars. Southern Pacific has sidetracked 12,000 cars. And 12 of the 16 rail unions representing 66,000 Conrail employees have approved deferring up to 12% in wage boosts over the next three years in an effort to keep the troubled rails operating. In a phrase, the bear is beginning to bite.



PTI: In the preceding Letter I included a 2 x 6 point & figure chart of the Primary Trend Index. That was a fairly detailed chart with each box representing 2 points on the PTI. This time I am showing a 4x12 chart of the PTI. On this chart each box is a full 4 points and only reversals (rallies or declines) of 12 points or more are entered. Thus, this chart takes in much more territory but it is less detailed.

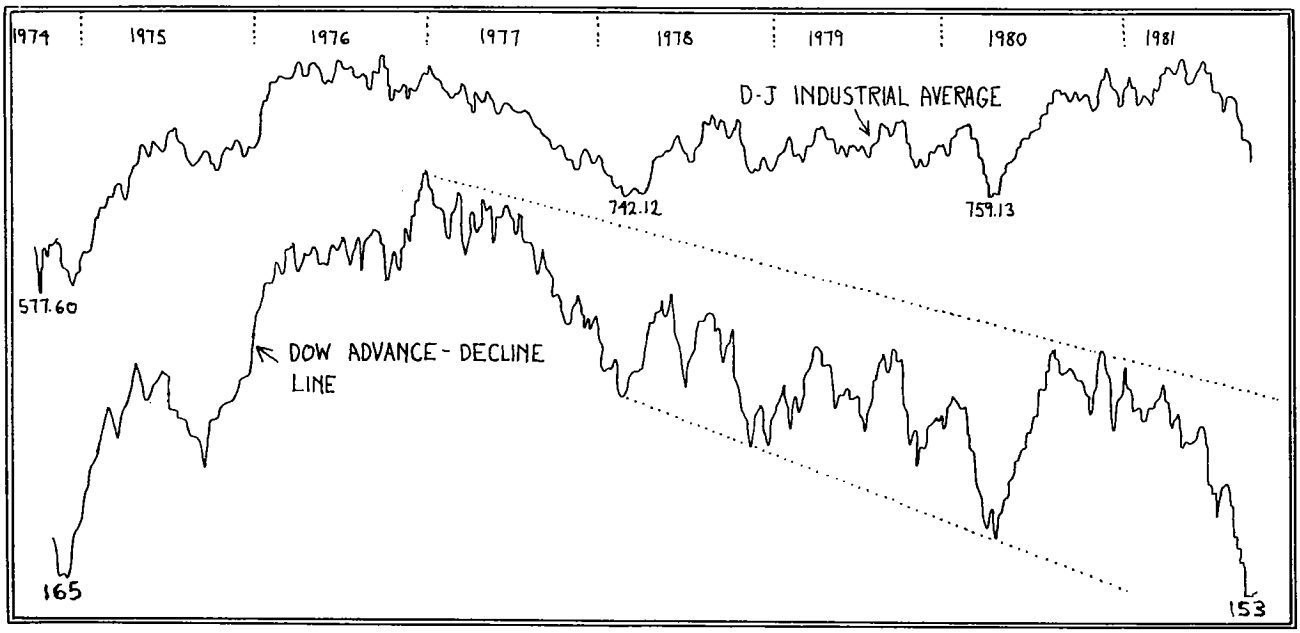
What we see here is the massive rise from the 1072 low of 1979 to the 1508 box of 1981. From 1508 the PTI turned down, giving a sell signal at 1464 and a second sell signal at 1428. The decline carried to the 1396 box.

The pattern on the chart is beginning to resemble a giant head and shoulders top with the PTI now seemingly working on the right shoulder. Any rally here could complete the right shoulder on this pattern. Thereafter, a new decline (below 1388) could set off the next major decline in the PTI.

Such a decline (if it develops) would be most ominous. Why? Because a break below 1388 would project a decline of around 120 points in the PTI, and that (to put it mildly) would be a disaster.

DOW ADVANCE DECLINE LINE: I show on page 3 a long term chart of the daily A-D line for the 30 D-J Industrial stocks. This index is tabulated by computing the pluralities of advances over declines (or vice versa) for the thirty Dow Industrials on a daily basis.

To put it mildly, this is an astounding chart. On a long-term basis, the Dow Average since 1974 has recorded a series of rising bot-



toms, the 577.60 low of 1974, the 742.12 low of early-1978 and the 759.13 low of early-1980. The picture for the Dow A-D line is one of both long-term and near-term divergence. I have dramatized this divergence by enclosing all the action since early-1977 within two declining trendlines.

Since early-1977 the trend of the Dow A-D line has been down with each peak below the preceding peak and each low below the preceding low. As seen on the chart, the Dow A-D line has during 1981 crashed below all bottoms going back to 1974. This breadth collapse has serious implications.

With breadth in the Dow now actually below its 1974 low, the market is in a precarious technical position. I would think that in due time the Dow could start confirming its own breadth, and it would do this by breaking below the various lows going back to 1974. If this is to occur, the first target for the Dow is the 759.13 low of 1980.

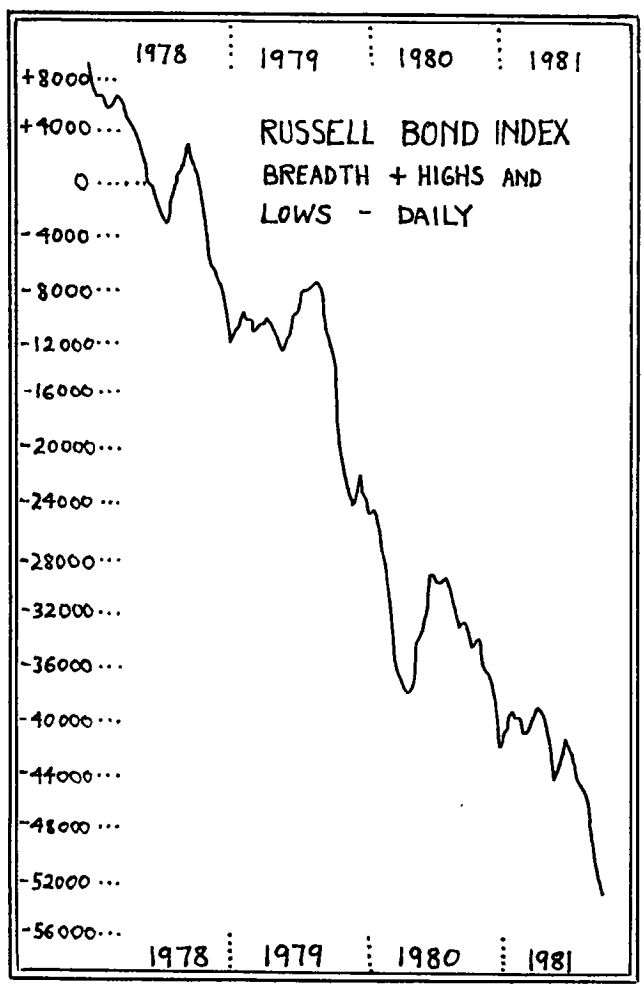
The lower the Dow A-D drops, the greater the technical vacuum created by the Dow/Dow A-D divergence. But the divergence is stretched so taut now that it is hard to envision a continuation of the Dow A-D collapse without an accompanying cave-in in the Dow.

INVESTMENT POSITION: The real return on savings (interest rates minus the inflation rate) is currently just under 6%. This is the highest real return in modern history. Investors who like money understand this, and they are currently holding money instruments. The instruments I have been recommending are the 91-day Treasury bills, currently yielding over 14% (no state taxes are paid on T-bills).

T-bill holders have enjoyed the double advantage of (1) a high real rate of return, and (2) avoiding a vicious bear leg on the NYSE (on the Amex the price average is down almost 30% in five weeks!). My advice: stay in T-bills and watch the show.

MONEY: Despite Merrill Lynch's monster June advertising campaign proclaiming "The Dawn of a New Bull Market" the bond market has continued to strangle in the grip of the bear. My broadest measurement, the Russell Bond Breadth Index, has tumbled to an all-time low along with the D-J 20 Bond Average.

The Russell Bond Index is tabulated by taking the daily advances (NYSE Bond Exchange) plus new highs and subtracting daily declines plus new lows. These are added up weekly and entered on the accompanying chart.



The chart gives us some idea of the frightful carnage in the bond market. Prices have plunged so persistently and so acutely that many observers are fearful that there will be no active market for longer term bonds before long. The US Government will be dismayed to hear that, since it depends on the bond markets to digest its regular sales of US securities. The hippies used to ask jokingly, "What if they gave a war and nobody came?" Now Wall Street asks, "What if they brought out an issue of Government bonds and nobody bought?"

I continue to receive requests which basically boil down to, "Where should I keep my money?" The answer is 91-day Treasury bills. These can be rolled over every 91 days by your bank or broker at a cost per roll-over of about $25 for any amount.

For smaller amounts, money can very conveniently be kept in one of the money market funds. The funds I recommend are invested strictly in Government paper, and I list three very acceptable funds below. Please don't write and ask if Muni bonds, FNMA paper, Freddie Mac or AAA bonds are acceptable. Don't make me write "No, no, no" endlessly, just stick to my suggestions and save both you and me much agony. Many thanks.

(1) *Capital Preservation*, 755 Page Mill Rd., Palo Alto, CA 94306 (800-982-6150 in CA and 800-227-8380 outside CA). This fund deals strictly with T-bills. *Capital Preservation II* deals in Government repos and is also on my "good" list. Call them for information.

(2) *Fund for Government Investors*, 1735 K St., NW Washington DC 20006 (call collect 202-861-1810). This fund holds T-bills, notes, bonds, and Government agency paper. Current yield is 17% and average maturity is 17 days.

(3) *Merrill Lynch Gov't Fund*, 125 High St., Boston, MA 02110 (800-225-1576). This fund holds T-bills and T-notes, currently yields 16.1% and has average maturities of 10 days.

Question: Russell, you write about the three phases of a bear market, you write about a primary bear market that could correct all the action since 1974, you use the term "major bear market." But how do you know that we haven't already seen most of this bear market? How can you be sure that this bear market won't end, for instance, next week or next month?

Answer: In this kind of environment, in a nation eaten up by debt and high interest rates, one tends to think in terms of major (disastrous) bear markets, at least I do. Even though the odds are always heavily weighted against a huge bear market (disasters are very rare), the damage that could be caused by a major bear market is so potentially hazardous that I am always on the lookout for such an event. In other words, once I have decided that we are in a bear market (and we ARE in one now), I also pay the cost of insurance by acting as if it will be a major (disastrous) bear market.

Question: What do you mean by the cost of insurance?

Answer: That cost is the cost of taxes and commissions in selling out stocks. If you deal with no-load funds (and I advocate this), then obviously there is no cost as far as commissions are concerned.

I operate on the thesis that an investor's number one duty is to protect his capital. A bear market is the major danger to capital. Therefore, one must always guard against a bear market, and this entails the cost of selling out and getting on the sidelines.

Question: But I still don't know why you think that this could be a major bear market? Why are you so cautious now?

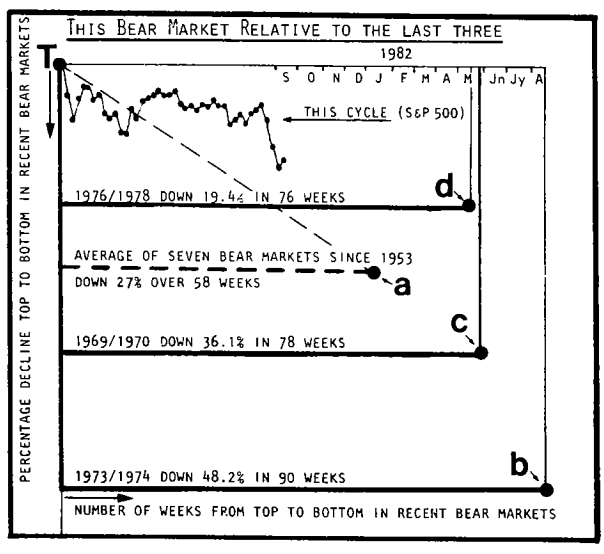
Answer: For one thing, we did receive a primary bear signal under Dow Theory on July 2, 1981. The signal was almost *totally ignored* by the investment fraternity, and I felt that was ominous (and I wrote about it at the time).

Then there is the matter of the Primary Trend Index. My Index has not had a real correction since 1974 although there have been many minor and secondary corrections. But the major rising trendline which started in December, 1974 has not been even vaguely approached in seven years. The longer the time lapse without a major bear market correction, the better the odds that such a correction will arrive.

Finally, the high level of debt (including NYSE margin debt) suggests that a major bear market was near. With interest rates now compounding the nation's debt at an almost exponential rate, the odds for a bear market increase. Then there is always the chance that the nation's finances could get completely out of control. At this stage of the cycle, with debt pressing on every level of the American economy, any recession could quickly turn into a depression. Thus, the groundwork is laid for a major bear market. Such a bear market could begin at any time and is, I believe, in force now.

Question: If we are in a major bear market, how far would you expect it to go – and for how long?

Answer: Here, any answer is merely a guess. My friend Ian McAvity just drew up this superb chart comparing this bear market with other bear markets of recent years. The chart shows


THIS BEAR MARKET RELATIVE TO THE LAST THREE
1982
S O N D J F M A M Jn Jy A
THIS CYCLE (S&P 500)
1976/1978 DOWN 19.4% IN 76 WEEKS
d
AVERAGE OF SEVEN BEAR MARKETS SINCE 1953
DOWN 27% OVER 58 WEEKS
a
c
1969/1970 DOWN 36.1% IN 78 WEEKS
1973/1974 DOWN 48.2% IN 90 WEEKS
b
T
PERCENTAGE DECLINE TOP TO BOTTOM IN RECENT BEAR MARKETS
NUMBER OF WEEKS FROM TOP TO BOTTOM IN RECENT BEAR MARKETS

the comparisons. So far, this bear market is shorter in duration and extent than the average (A on chart) of seven bear markets since 1953. And compared to the 1969-70 bear market (C on chart) or the 1973-74 bear market (B on chart), this bear has a long way to go.

Question: How convinced are you that this bear market is going lower?

Answer: I can't guarantee anything, but I think it will go lower. Nevertheless, I do take it as it goes, one day at a time. I continue

to monitor all my indicators, particularly the PTI. From what I see, this bear is not through. But I try to avoid preconceived notions, "heroic" predictions and professional ego trips. However, my feeling continues to be (from evidence to date) that this bear market has further to go on the downside. Certainly, my point & figure projection (based on the PTI chart) indicates this.

NOTES & QUOTES: Progress report: during the first nine months of the Reagan Presidency, the US Government increased its work force by 43,000.

* *

High interest rates and declining farm prices have hit the US farmer hard. It has also sent farm supply companies into the tank with International Harvester now on the edge of bankruptcy. The number of people connected with farm work has also dropped dramatically. In 1920 almost 25% of America was on the farm. In 1980 less than 5% work in agriculture. Yet the need for food was never greater. A strange course for one of the world's great industries. Ironically, agriculture is probably the industry that the US competes in best – on a world basis.

* *

Today I spoke to my military expert friend, Melvin Lippman, publisher of US Organization Chart Service, here in La Jolla. Melvin tells me that both the MX and the B-1 are simply stop-gap concepts. Neither is a "next generation" item. Melvin states that a new generation bomber is on the hopper, but the B-1 "ain't it." He also says that military spending is headed into outer space. The "big spending," he adds, "is actually slated for 1985-86 and beyond."

If that's true, I muse, where is the money coming from? Are they going to cancel all the social programs, are they going to monetize new billions of dollars? I conclude that we're on a collision course with the social programs and the military being the basics of the coming collision. "I'm telling you," repeats Lippman, "the military spending is in the hopper. There will be no stopping it. By the way, " he queries, "How does your collision course end?"

"It ends in a collision," I reply, "and that's probably what this bear market is all about."

* *

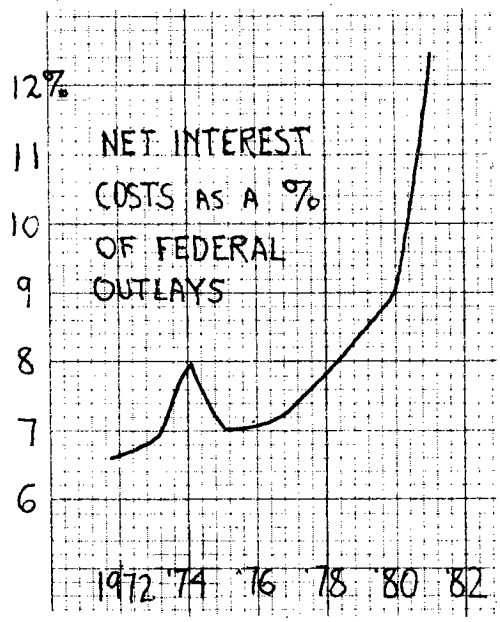
I just heard that my friend, Morgan Maxwell, was killed in the crash of his two-engine plane outside Kansas City. Morgan (age 40, and a self-made millionaire) was a highly intelligent, hard-hitting entrepreneur. He was featured on the cover of *Fortune Magazine,* he published an investment letter, he was a hard money advocate and a frequent speaker at investment seminars. It was about three years ago that I wrote about my early morning jog with Morgan, a jog that took us around the New Orleans Super Dome. I noted that I had trouble keeping up with Morgan. He was a bundle of energy.

I had many long intimate talks with Morgan about both our lives. Morgan was a shooting star, and last year I said to him, "Morgan, you're heading for somewhere in a big hurry, but I don't know exactly where." Morgan ran for the US House in 1976, but lost in the primary to an opponent who (ironically) died in a plane crash on the night he won the primary.

Morgan, I'll miss you. Morgan, you've finally found some rest. Morgan, we hardly knew you.

* *

This chart shows the effect of rising debt and accompanying rising interest rates. Back in 1972 interest rates as a percentage of total Federal outlays amounted to about 6.5%. This year interest rates will be about 12.5% of total US outlays. As the debt rises the compounding effects of interest rates will continue to spiral higher. Nothing will interrupt this climb except a dramatic de-



cline in the deficit which means a concerted shift toward balancing the budget. Tragically, as interest rates climb and as budget expenses rise, it becomes progressively more difficult (more painful) to move towards balance. This is why I have stated repeatedly that the deficit-building process is just another way of saying that the nation "is eating itself up alive."

* *

Gambling Casino owners may fleece the public, but when it comes to the markets they're just amateurs. *Resorts International* earned about $17 million in the third quarter. But they lost $25 million on Treasury bond futures. Moral: when you have a sure thing like a gambling casino, don't get greedy and try to out-guess the money markets.

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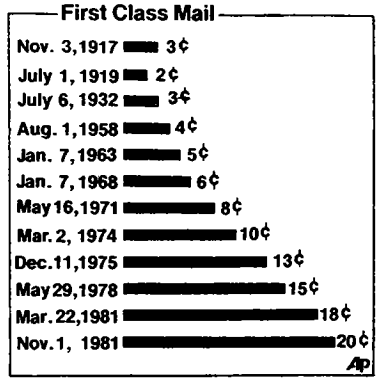
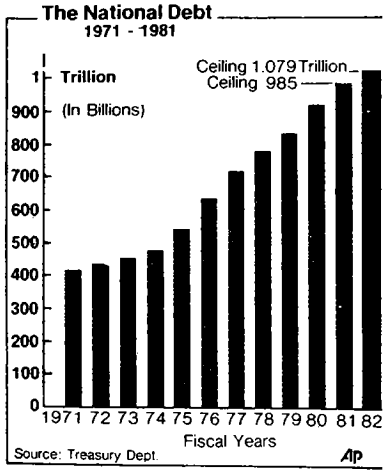
A Tale of Two Charts: These two charts tell a tale of Government inefficiency and incompetence. Both charts affect everyone, and it keeps getting worse.





Emmet Fox: Dr. Emmet Fox was a great preacher, sermonizer, and writer who gained fame during the 1930's and '40's. Dr. Fox wrote many books, most of which are still in print (Harper & Row). I often read and re-read Emmet Fox's writing, and I never fail to learn something from each reading. Following are a list of definitions from Fox's book *"Make Your Life Worthwhile":*

A Scientist is one who asks "How?"

A Philosopher is one who asks, "Why?"

A Mystic is one who sees life from the inside.

A Materialist is one who sees life from the outside.

A Poet is a master of language.

A Politician is one who puts his party or his career first.

A Statesman is one who puts the country first.

An Artist is one who makes beauty a religion.

A Hero is one who does the kind of thing that others are content to admire.

A Coward is one who sees the higher and chooses the lower.

A Fool is one who thinks that the Great Law can be evaded (cheated).

A Thief is one who tries to get something, on any plane, which he has not earned.

A Gambler is one who thinks he can gain something which does not belong to him by right of consciousness.

A Youthful person is one who is never bored.

An Elderly person is one who has lost the capacity for wonder.

A Pharisee is one who uses God to glorify himself.

A Quack is a doctor of any school who treats symptoms instead of causes.

* *

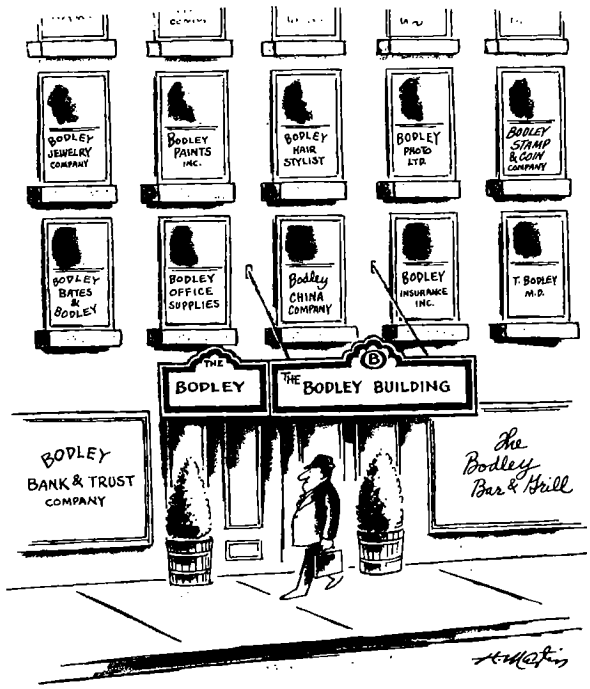
This isn't inflation. A Tiffany ad appearing last week.

SILVER PRICES

Throughout the fluctuations of the silver market, we have protected the interests of our customers by maintaining the fairest possible prices.
In April we reduced Tiffany silver prices by 25%.
We are now pleased to announce new
reductions of up to 33%
effective immediately
on all flatware patterns made by Tiffany's silver shop.
This represents a total reduction of approximately 50% since the first of the year.

TIFFANY & CO.
SAN FRANCISCO 252 GRANT AVENUE · ZIP 94108 · PHONE (415) 781-7000

Everybody in the investment world knows what a conglomerate is. But the *New Yorker* has its own idea of a conglomerate, and I got a real laugh out of this cartoon.



GOLD: Not much happening to the precious metals. Maybe the moving averages tell the story best. The 5-week MA for gold is now 439, just four points above the 13-week MA, which stands at 435. Thus, the near-term trend of gold is mildly bullish. But both of the shorter-term MA's are well below the 50-week MA, which now stands at 482. After being at 98 last week, the gold momentum (13-week rate of change) dropped to 95 on the week ending October 3.

Thus, I see gold in a bullish-neutral position – not particularly exciting for goldphiles or gold phobes. As far as the Government gold commission is concerned, it was a typical Government investigation – no conclusion was drawn. The Commission couldn't even agree on gold's history, much less gold's future.

Latest supply-side slogan: nothing good can happen until the dollar is backed by gold. My opinion: maybe so but just for kicks try balancing the budget!

LATE NOTES: Following seven out of eight down-weeks, the market has launched into a rallying phase. This should hardly come as a surprise. We'll give the market ample time to enjoy a few fireworks on the upside, and we'll watch the PTI to see what develops.

NEXT MAILING: Oct. 21